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Bridging the Week by Gary DeWaal: October 15 - 19 and October 22, 2018 (Bitcoin Fraud; Smart Contracts; Actual Delivery; Reg AT)

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The Commodity Futures Trading Commission obtained orders from a federal court in New York concluding its first-filed enforcement action against persons for bitcoin fraud. However, the outcome of an unrelated action having nothing to do with cryptocurrencies and pending in a federal court of appeals in California may have greater implications for the CFTC's cryptocurrency enforcement efforts going forward. Separately, CFTC Chairman J. Christopher Giancarlo announced before an industry gathering last week that Reg AT – a 2015 Commission proposal to augment regulations regarding algorithmic trading purportedly to mitigate risks – was officially dead. Likely, no algorithmic traders mourned. As a result, the following matters are covered in this week's edition of *Bridging the Week*:

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Antitrust & Trade Regulation
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Article Version:

Briefly:

- **CFTC Concludes First Bitcoin Anti-Fraud Enforcement Action With Assessment of Over $2.5 Million in Fines and Restitution**: The Commodity Futures Trading Commission's first enforcement action alleging fraud in connection with the offer and sale of a cryptocurrency was resolved last week through orders of a federal court in New York against Gelfman Blueprint, Inc. and Nicholas Gelfman, its chief executive officer and head trader.

In September 2017, the CFTC filed charges against Gelfman Blueprint and Mr. Gelfman for conducting an alleged Ponzi scheme involving bitcoin. This enforcement action represented the first time the CFTC used its authority granted under the Dodd-Frank Wall Street Reform and Consumer Protection Act to prosecute an alleged manipulative or deceptive device or contrivance in connection with a cryptocurrency in interstate commerce. (Click here to access CEA Section 6(c)(1), 7 U.S.C. § 9(1).) No derivative based on a cryptocurrency was alleged to have been involved.

The Commission claimed that from January 2014 through January 2016, the defendants solicited approximately US $600,000 from at least 80 customers to trade bitcoin in a pooled fund using a proprietary algorithm called "Jigsaw." However, charged the CFTC, the defendants misappropriated most of this money for their own use and rarely traded for customers. The defendants also misled investors and potential investors through false and misleading statements.

Mr. Gelfman personally consented to an order of permanent injunction and imposition of a fine, restitution and a trading ban to resolve the CFTC's enforcement action. The court approved an equivalent default order against Gelfman Blueprint. Under the terms of their orders, Gelfman Blueprint and Mr. Gelfman are required to pay fines and restitution of more thanUS $2.5 million, combined. Previously, Mr. Gelfman pleaded guilty to one count of petit larceny in connection with a New York criminal prosecution deriving from the same underlying facts as the CFTC's enforcement action.

(Click here for background regarding the CFTC's enforcement action in the article "CFTC Files Charges Alleging Bitcoin Ponzi Scheme Not Involving Derivatives" in the September 24, 2017 edition of *Bridging the Week*.)

Although the CFTC's enforcement action against Gelfman Blueprint and Mr. Gelfman was the Commission's first enforcement action alleging fraud in connection with the offer and sale of cryptocurrencies, it has filed subsequent enforcement actions on a similar theme, obtaining a permanent injunction and sanctions in one case – against Cabbagetech Corp. and Patrick McDonnell – and prevailing in a motion to dismiss in another – against My Big Coin Pay, Inc., Randall Crater and certain relief defendants. (Click here for background regarding the Cabbagetech enforcement action in the article, "Federal Court Enters Final Judgment Against Alleged Virtual Currency Fraudster; Confirms CFTC Authority to Bring Enforcement Action" in the August 26, 2018 edition of *Bridging the Week* and here for a discussion concerning My Big Coin Pay in the article "Second Federal Court Rules That Cryptocurrencies Are Commodities and CFTC Has Anti-Fraud Jurisdiction Over Alleged Wrongdoing" in the September 30, 2018 edition of *Bridging the Week*.)

Among other developments involving crypto-assets this past week:

- CFTC Commissioner Warns Just Because It's Decentralized Doesn't Mean It's Not Regulated: In a speech delivered in Dubai, CFTC Commissioner Brian Quintenz warned that products and transactions within the Commission's jurisdiction are subject to the CFTC's regulation even if they are executed on a blockchain utilizing smart contracts. If there are violations of laws or regulations, it may be challenging to identify who is responsible, he said, but someone is. Mr. Quintenz suggested that code developers could be likely targets for unlawful uses of a smart contract if they could reasonably foresee at the time they created the relevant code that it would likely be used by US persons in a prohibited fashion. The CFTC commissioner noted that "[s]mart contract applications on blockchain networks hold great promise. … At the same time they also raise novel issues of accountability that users and policy makers alike must consider." Smart contracts are self-executing agreements functioning on a blockchain with all terms between a buyer and seller embedded into lines of computer code.

Earlier this year, Jitesh Thakkar was named in both a CFTC civil enforcement action and a Department of Justice criminal lawsuit in connection with his development of software that purportedly was used by Navinder Sarao in connection with Mr. Sarao's alleged spoofing activities. (Click here for background in the article "CFTC Names Four Banking Organization Companies, a Trading Software Design Company and Six Individuals in Spoofing-Related Cases; the Same Six Individuals Criminally Charged Plus Two More" in the February 4, 2018 edition of *Bridging the Week*.)

- Retail Metals Broker Says Lower Court Was Right on Interpretation of Actual Delivery and Limitation on CFTC Anti-Fraud Authority: Monex Credit Company and related companies and persons told a federal

appeals court in California that a federal district court got it right when it ruled against the CFTC in May 2018 regarding what constitutes actual delivery of metals under applicable law and the scope of the Commission's enforcement authority involving commodities, as opposed to derivates based on commodities. Monex made its declaration in papers filed with the court of appeals in opposition to the CFTC's effort to reverse the district court's decision.

Previously, the district court held that actual delivery of precious metals in financed transactions to retail persons falls outside the CFTC's jurisdiction when ownership of real metals is legally transferred to such persons within 28 days – the so-called "Actual Delivery Exception"– even if the seller retains control over the commodities because of the financing beyond 28 days.

The district court also ruled that the CFTC cannot use the Dodd-Frank prohibition against persons engaging in any manipulative or deceptive device or contrivance in connection with the sale of any commodity to prosecute acts of purported fraud except in instances of fraud-based market manipulation. (Click here for details regarding the district court's decision in the article "California Federal Court Dismissal of CFTC Monex Enforcement Action Upsets Stable Legal Theories" in the May 6, 2018 edition of *Bridging the Week*.)

Defendants in two recent CFTC enforcement actions charging fraud in connection with cryptocurrency activities – *Patrick McDonnell* and *My Big Coin Pay* – unsuccessfully tried to convince two different federal courts to follow the Monex district court's reasoning to escape the CFTC's jurisdiction.

- LabCFTC Meet SEC FinHub; SEC FinHub Meet LabCFTC: The Securities and Exchange Commission announced the launch of its Strategic Hub for Innovation and Financial Technology (FinHub) to serve as a resource for public engagement on fintech-related issues, including blockchain technologies and crypto-assets. Like the Commodity Futures Trading Commission's LabCFTC, FinHub will sponsor fintech-themed events and publications (including afintech forum on distributed ledger technology and digital assets scheduled for 2019) as well as provide a formal means for interaction with SEC staff.

- FATF Recommends Jurisdictions Apply AML Regulations to All Cryptocurrency Service Providers: The Financial Action Task Force recommended that all jurisdictions "urgently" take steps to prevent the misuse of cryptocurrencies, including subjecting all cryptocurrency service providers to existing anti-money laundering and combatting the financing of terrorism regulations. According to FATF, such service providers should be required to conduct customer due diligence, including ongoing monitoring, recordkeeping and suspicious activity reporting. FATF is an intergovernmental body established in 1989 by member jurisdictions to set standards and help implement legal and operational measures to combat money laundering, terrorist financing, and other related threats to the soundness of the international financial system. (Click here for background on FATF.)

Legal Weeds: A decision by the California federal appeals court in favor of Monex upholding the lower court's decision would have a chilling effect on the CFTC's enforcement efforts against persons selling virtual currencies who do so on leverage or who engage in alleged fraudulent practices. This is because such a ruling would raise questions regarding the CFTC's authority to bring such actions in the first place.

In 2016, the CFTC settled an enforcement action against BFXNA Inc. d/b/a Bitfinex, claiming that the firm operated a platform that enabled retail persons to buy and sell virtual cryptocurrencies and to finance their transactions. However, because Bitfinex purportedly retained control over such transactions after the financing – much like the CFTC alleged against Monex – the CFTC alleged that actual delivery did not occur. As a result, the transactions were akin to futures contracts, and Bitfinex should have been registered as an FCM in order to engage in such activities, said the CFTC. (Click here for further details regarding this CFTC action in the article "Bitcoin Exchange Sanctioned by CFTC for Not Being Registered" in the June 5, 2016 edition of *Bridging the Week*.)

Moreover, late last year, the CFTC proposed guidance that, for sales of virtual currency to retail persons, the Commission would consider "actual delivery" to have occurred only when such persons could take "possession and control" of all purchased cryptocurrency, use it freely no later than 28 days from the date of an initial transaction and do so unencumbered. This would require neither the offeror nor the seller, or any person acting in concert with such persons, to retain any interest or control in the virtual currency after 28 days from the date of the transaction. This would presumably preclude a seller from retaining control over the cryptocurrency by having authority over a wallet containing such commodity even when the seller financed the purchase. (Click here for details regarding this proposal in the article "CFTC Proposes Interpretation to Make Clear: Retail Client + Virtual Currency Transaction + Financing + No Actual Delivery by 28 Days + No Registration = Trouble" in the December 17, 2017 edition of *Bridging the Week*.)

If the federal appeals court hearing the CFTC's *Monex* action upheld the district court's decision, the ruling could serve as compelling precedent for persons to challenge the CFTC's jurisdiction over financed virtual currency transactions (as well as other financed commodity transactions) to retail persons where sellers retain control to

protect their loans.

Additionally, the CFTC has liberally applied the Dodd-Frank law that prohibits the use or employment of any manipulative device, scheme or artifice to defraud, as well as the parallel CFTC rule. (Click here to access CFTC Rule 180.1) This is because the CFTC has regarded the provision of law "as a broad, catch-all provision reaching fraud in all its forms – that is, intentional or reckless conduct that deceives or defrauds market participants."

Relying on these provisions, the CFTC has brought a wide range of enforcement actions, including the JP Morgan "London Whale" case, and cases based on allegations of illegal off-exchange metals transactions, claims of more traditional manipulation of wheat, allegations of spoofing, claims of insider trading, and more recently, other allegations of cryptocurrency fraud. (Click here for a general background in the article "CFTC Brings First Insider Trading-Type Enforcement Action Based on New Anti-Manipulation Authority" in the December 6, 2015 edition of *Bridging the Week*.)

An adverse ruling for the CFTC in the court of appeals hearing *Monex* could force the CFTC to more narrowly focus its enforcement activities under the Dodd-Frank provision, restricting the Commission to bring lawsuits only where it can allege that a purported fraud affected the market or constituted fraud-based market manipulation.

- **Reg AT Dead Proclaims CFTC Chairman**: At a speech at FIA Expo last week, J. Christopher Giancarlo, chairman of the Commodity Futures Trading Commission, said that he would not advance Regulation Automated Trading for consideration by the Commission in its current form. Although Mr. Giancarlo acknowledged he shared concerns about "the inevitability of some future market disruption exacerbated by automated trading algorithms," he said there was nothing in Reg AT that would "prevent such an event." Moreover, he claimed that adoption of Reg AT would give "a false sense of security that the CFTC had regulatorily foreclosed such market disruption, which is impossible."

The CFTC initially proposed Reg AT in November 2015. The provisions, if adopted, would have imposed extensive new requirements on certain existing CFTC registrants that used automated trading systems, required the first-time registration as a floor trader of many persons who used algorithmic trading systems to electronically and directly route orders to designated contract markets, and allowed for the inspection without subpoena by the CFTC and Department of Justice of proprietary algorithmic trading systems' source code. The CFTC proposed an amended version of Reg AT in November 2016. (Click here for background on both the initially proposed and revised versions of Reg AT in the article "Proposed Regulation AT Amended by CFTC; Attempts to Reduce Universe of Most Affected to No More Than 120 Persons" in the November 6, 2018 version of *Bridging the Week*.)

Reaction to the CFTC's proposed initial and amended rules to address algorithmic trading was mostly unfavorable. (Click here for a summary of reactions to the CFTC's amended version of Reg AT in the article "Supplemental CFTC Regulation AT Proposal Generally Criticized as Too Prescriptive" in the May 7, 2017 edition of *Bridging the Week*.)

Mr. Giancarlo indicated that he would be "quite open" to consider whether any elements of proposed Reg AT might serve as a basis for another more effective rule that addressed risks of automated trading.

My View: Reg AT was a no-go from the start.

At the time it proposed Reg AT, the CFTC acknowledged the multitude of existing best industry practices and many rules and requirements of designated contract markets and the National Futures Association already in place to mitigate the risks of algorithmic trading. Notwithstanding, the Commission recommended piling on additional layers of highly detailed requirements that would have added, at most, marginal benefits, while imposing substantial additional costs.

Moreover, in an effort to enhance compliance with what are now best practices, the CFTC potentially would have caused some trading firms to consider not implementing new and innovative risk control procedures and even rolling back already relied-on best practices. This is because the CFTC initially proposed to elevate to a regulatory incident the failure of an AT Person to comply with its own compliance procedures, in addition to relevant law and rules. This would have discouraged algorithmic trading firms from implementing as a formal requirement any best practice above a CFTC minimum requirement, when its reward for being innovative and top in class could be a potential regulatory violation and sanction.

Most egregious, the requirement that AT Persons make available their source code to CFTC and US Department of Justice staff for inspection — not solely pursuant, as now, to subpoena or other lawful process of law — was a substantial if not unconstitutional overreach, opening AT Persons to potential compromises of their proprietary innovations.

The better way to achieve many of the good objectives of Reg AT has always been to build upon approaches already implemented by DCMs and the NFA, let alone by the proprietary trading industry itself, and to encourage

the development and implementation of further best practices rather than construct a new regulatory infrastructure.

Mr. Giancarlo objected to Reg AT when it was proposed, and fortunately has formally killed the proposal entirely now.

More Briefly:

- **Multiple Nonmembers Held Liable for Disruptive Trading by NYMEX and COMEX and for Not Participating in Disciplinary Process**: Business conduct committees of the Commodity Exchange, Inc. and the New York Mercantile Exchange penalized numerous nonmembers for engaging in disruptive trading practices as well as not participating in exchange disciplinary actions. Li Mian Feng, Jang Woo Suk and Sung Yong Kim were each sanctioned for purported spoofing, after not answering charges brought against them. Mr. Fang was fined US $80,000 by COMEX and NYMEX BCCs, Mr. Kim, US $70,000 by COMEX and NYMEX BCCs, and Mr. Suk, US $60,000 by a COMEX BCC. Separately, Xiang Lin was fined US $60,000 by COMEX for placing copper futures orders with the intent to cancel them before execution as well as not participating in an exchange investigation. Each of these individuals were also subject to temporary or permanent trading bans from all CME Group exchanges. Finally, Jae Myun Ko was also subjected to a permanent trading ban from all CME Group exchanges by COMEX and NYMEX BCCs solely for not participating in the exchanges' investigatory process.

- **CBOE Exchanges Fine Member for Not Stopping Excessive Order Messaging Activity**: Group One Trading, L.P., a member of the Cboe BZX and EDGX exchanges, was fined US $62,500 by the exchanges for not having risk management controls and supervisory procedures for market access reasonably designed to prevent numerous instances of potentially excessive options quote messaging activity from February 1, 2016, through August 31, 2017. Cboe claimed that, for the relevant time period, it identified more than 13,500 instances of excessive options quote messaging that was caused by a system bug that caused individual traders' option quoting on particular exchanges to be affected by other internal traders' quoting of the same option on the same exchange as opposed to external market conditions. Cboe said the firm's automated pre-order entry controls did not detect this internal looping problem because they were not designed to detect aggregate quote messaging by all firm traders for an option in one venue or across multiple venues; they were designed solely to detect problematic messaging by individual traders. The exchanges claimed that Group One's actions violated the Securities and Exchange Commission's Regulation Market Access. Reg MAR – adopted by the Securities and Exchange Commission in 2010 – generally requires a broker or dealer with access to trading securities directly on an exchange or alternative trading system to have procedures and controls reasonably designed to limit their financial exposure as a result of such access and ensure compliance with all applicable regulatory requirements. (Click here to access Reg MAR, SEC Rule 15c3-5. Click here for helpful answers to frequently asked questions related to Reg MAR provided by the SEC's Division of Trading and Markets.)

- **SEC Rules Against Two Exchanges Raising Market Data Fees**: The Securities and Exchange Commission set aside depth-of-book market data feed fee increases by NYSE Arca, Inc. and Nasdaq Stock Market LLC because the exchanges did not establish that the increases were fair and reasonable and not unreasonably discriminatory. The SEC's decision was in response to a challenge in 2010 by The Securities Industry and Financial Markets Association that the fee increases violated applicable law (click here to access Securities Exchange Act Section 11A(c)(1)(C) and (D), 15 U.S.C. § 78k-1(c)(1)(C) and (D)). NYSE Arca and Nasdaq had argued that two competitive forces – competition for order flow and the availability of alternative solutions – precluded them from imposing unfair and unreasonable pricing. However, the SEC claimed that the exchanges did not provide sufficient facts or legal arguments to support their claims. This is the first time the Commission has rejected a fee hike for market data products. Simultaneously with its determination, the SEC remanded 400 other challenges to exchanges' market data and market access fees that also had been submitted to it back to the relevant exchanges for further consideration in light of the SEC's order.

- **Global Banking Supervisors Seek Views on Modifying Capital Treatment of Customer Collateral for Centrally Cleared Derivatives**: The Bank of International Settlements' Committee on Banking Supervision agreed to consider amending its leverage ratio requirements for banks clearing derivatives for customers by potentially authorizing margin posted by customers to be counted as an offset for banks' replacement future exposure for client-cleared derivatives. (The leverage ratio requires banks to hold a minimum amount of common stock and certain disclosed reserves – so-called "Tier 1" capital – as a percentage of their total exposure.) Comments will be accepted by the Basel Committee through January 16, 2019. Earlier this year, the Bank of England published a study showing that the imposition of leverage ratio requirements on banks for clearing customer derivatives – even when fully

margined – has resulted in banks reducing their willingness to handle customer business. (Click here for details in the article "Bank of England Study Says Banks Subject to Leverage Ratio Clear Fewer Client Transactions" in the June 24, 2018 edition of *Bridging the Week*.)

- **Public Companies Warned by SEC of Consequences If Cyber-Attacks Are Determined Attributable to Lax Internal Controls**: The Securities and Exchange Commission determined not to bring enforcement actions against nine public issuers of securities that each lost more than US $1 million because of cyber-attacks; two issuers lost more than US$30 million each, and in total, all the issuers lost nearly US $100 million. In all cases, wire payments were made in response to email requests from faked domains of legitimate company executives or foreign vendors. Although each of the issuers had procedures for certain levels of authorizations for payment requests, after the cyber-attack incidents, they enhanced these procedures as well as the processes related to changes in vendor information and account reconciliations. The SEC said that these attacks suggest the need for public issuers to assess their internal accounting controls in light of emerging risks, "including risks arising from cyber-related frauds." The SEC made its non-enforcement determination in a Report of Investigation issued under applicable law (click here to access Section 21(a) of the Securities Act of 1935, 15 U.S.C. § 78u(a)(1).)

- **SEC-CFTC Harmonization Briefing Hosted by Two CFTC Commissioners Not Violative of Sunshine Act Rules CFTC Inspector General**: The Commodity Futures Trading Commission's Inspector General issued a report concluding that a February 2018 meeting hosted by two commissioners to hear presentations by CFTC and Securities and Exchange Commission staff on harmonization efforts did not violate legal requirements that mandate meetings involving at least the number of commissioners required to take an action on behalf of the agency to be open to the public. (Click here to access the relevant provision of the Sunshine Act, 5 U.S.C. § 552b.) The Inspector General concluded that, although it would have been better to have had all CFTC commissioners present at the meeting (at the time there were three), applicable law was not violated because no deliberations were intended at the meeting because of the nature of the issues briefed. Moreover, following the meeting, no CFTC final rules were implemented related to the meeting. The Inspector General reviewed this matter because of a complaint by an unnamed private citizen and from the organization Public Citizen.

- **FinCEN Employee Arrested and Criminally Charged for Leaking Confidential SARs to Reporter; Two Former Bank Employees Convicted for LIBOR Manipulation**: Natalie Mayflower Sours Edwards, a senior employee with the Financial Crimes Enforcement Network of the US Department of Treasury, was arrested and criminally charged in a federal court in New York for providing to a news reporter copies of confidential suspicious activity reports related to Paul Manafort, Richard Gates, the Russian Embassy, Maria Butina and Prevezon Alexander, as well as related internal FinCEN emails. According to the criminal complaint, Ms. Edwards made copies of SARS and other documents on an external flash drive provided to her by FinCEN, and then took photos of SARs which she forwarded by text message to the reporter. Ms. Edwards is charged with engaging in her prohibited conduct from October 2017 through October 2018. When questioned by law enforcement agents, she initially denied having any contact with the news media. If convicted of the charged crimes, Ms. Edwards could be sentenced up to five years in prison. Unrelatedly, Mathew Connolly, aformer Deutsche Bank supervisor, and Gavin Black, a prior DB derivatives trader, were convicted by a jury in a federal court in New York of conspiracy and wire fraud for their role in a purported scheme to manipulate the London Internabank Benchmark Offered Rate.